VZCZCXRO3722
PP RUEHDBU
DE RUEHTA #1512/01 1541104
ZNY CCCCC ZZH
P 031104Z JUN 07
FM AMEMBASSY ASTANA
TO RUEHC/SECSTATE WASHDC PRIORITY 9651
INFO RUCNCIS/CIS COLLECTIVE 0191
RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEAIIA/CIA WASHDC
RUEBAAA/DEPT OF ENERGY WASHDC

C O N F I D E N T I A L SECTION 01 OF 04 ASTANA 001512

SIPDIS

SIPDIS

DEPT FOR EB; SCA/CEN (O'MARA)

E.O. 12958: DECL: 06/04/2017
TAGS: ECON EFIN PGOV KZ
SUBJECT: KAZAKHSTAN,S FINANCIAL SECTOR: A DANGER TO ITSELF
(AND OTHERS)?

REF: A. ASTANA 1243
¶B. ASTANA 1240
¶C. ASTANA 1122
¶D. ASTANA 1234

Classified By: Pol-Econ Chief Deborah Mennuti; reasons 1.4 (b) and (d).

¶1. (SBU) Summary: In spite of the failure of a regional bank and the International Monetary Fund's recent characterization of Kazakhstani private sector external borrowing as an emerging "global market risk," the mood among Kazakhstani financiers remains upbeat. With no end to petrodollars in sight, they see major opportunities for growth in financial services, particularly insurance and asset management. Still, the IMF's focus on the size of Kazakhstani banks' external borrowings has helped highlight the Kazakhstani economy's vulnerability to higher global interest rates as another risk to the country's financial system. Most well-informed observers are already concerned by the apparent real estate bubbles in Astana and Almaty. Even more, when speaking frankly, acknowledge that the twin deficits of proper corporate governance and the rule of law remain major obstacles to the development of Kazakhstani business in general and the financial sector in particular. End summary.

Driven by Oil and Intent to Keep Going

¶2. (SBU) However they may assess the principal economic risks, decision-makers in the Kazakhstani financial sector agree that oil will, for the foreseeable future, continue to fuel the Kazakhstani economy and, concomitantly, the financial services industry. Roman Solodchenko, CEO of Bank Turan Alem (BTA), told a visiting Treasury official and econoff on April 16 that the outlook for the Kazakhstani economy remains rosy, as oil prices are not expected to plunge. Even if oil does fall, Solodchenko noted, it will still support economic growth, because oil contracts are structured in such a way that the actors are interested in increasing production "no matter what the oil price does." Furthermore, Solodchenko implied, the Kazakhstani Government's (GOK's) ongoing sterilization of its oil revenues through the National Fund has limited the government budget's dependence on the oil sector, thus cushioning the economy against any dramatic falls in the price of oil.

¶3. (C) Notably, Kazakhstan's National Bank (NBK) Deputy Chairman Gulbanu Aimanbetova does not see oil's classic side effect, "Dutch disease," as a significant problem for the Kazakhstani economy. She explained during an April 17 meeting that Kazakhstani firms rely heavily on imports for their inputs, citing the example of Rakhat Candy, which

imports 70-80% of its inputs. Tenge appreciation, therefore, does not necessarily have an adverse effect on the global competitiveness of Kazakhstani producers, since it helps lower their costs, according to Aimanbetova. (Note: Aimanbetova may have merely been restating the GOK's official position, which another NBK official described as "Kazakhstan does not have Dutch disease, just the symptoms." Whatever the GOK's principal decision-makers think of the threat of Dutch disease, however, they are currently embarking on a new major effort to diversify the economy away from the extractive sector. Ref A, B, and C. End note.)

Kazakhstan: Attracting Capital (and Notoriety)
-- -

¶4. (SBU) While oil-funded economic optimism is the spirit of the day, views appear to be significantly more diverse in regard to the Kazakhstani private sector's current borrowing binge abroad. The already much-discussed phenomenon was featured in the IMF's April 2007 Global Financial Stability Report. The IMF report specifically highlighted the combined external borrowing by Russia's and Kazakhstan's private sectors as "an emerging market risk." The report makes particular note of the external borrowing by Kazakhstani banks. In 2006, according to IMF figures, Kazakhstan's financial institutions borrowed $8.4 billion abroad; in just the first 44 days of 2007 (Jan. 1 through Feb. 13), they borrowed $6.3 billion. The report sees this as a factor in the context of "global risks," due to Kazakhstan's "relatively low capital adequacy" and "relatively high nonperforming loans ratio," particularly when the country's rapid credit growth is taken into account.

¶5. (C) One prominent actor in Kazakhstan's financial sector

privately called the IMF's decision to place Kazakhstan alongside the U.S. and Russia "flattering." Some well-informed observers expressed to us the view that the causes of the Kazakhstani private sector's borrowing binge were rational and benign, rather than speculative and dangerous. Kazakhstan's banks, they explained, are turning abroad to access long-term capital that they cannot obtain at home. Magzhan Auezov, Managing Director of KazKommertsBank (KKB), remarked, "it's just that borrowing abroad is cheaper," echoing the often-stated view that Kazakhstan's banking system, although widely described as the most-developed in the CIS, is not an adequate source of long-term capital. Some bankers explained that while the public-at-large continues the gradual post-Soviet process of warming up to banking, deposits remain relatively small and "flighty." As a result, the argument goes, the domestic market only provides banks with limited, short-term capital, forcing seekers of long-term capital to go abroad.

¶6. (C) NBK's Aimanbetova, however, stated unequivocally her concern with the extent of the banks' external borrowing. Kazakhstan's external debt - now at $73 billion - has, she said, greatly expanded in the past two years due to private sector borrowing. Banks are currently responsible for 45% of the country's external debt, she added. Aimanbetova also said that banks are becoming overly aggressive as they drive up interest rates in competition for deposits. Erlan Balgarin, CEO of Centras Securities, an Almaty-based investment company, was more blunt in an April 16 conversation. Credit expansion, he said, represents a serious risk to the Kazakhstani economy. Banks enjoy a high ability to borrow but very limited investment opportunities, which leads them to provide loans to questionable projects. As a result, Balgarin concluded, the quality of the credit portfolio tends to be very low.

¶7. (SBU) The Financial Supervision Agency (FSA) recently tried to limit banks' external borrowing by instituting stricter reserve requirements. As these requirements take effect, some of the largest banks are turning to issuing

equity abroad or seeking foreign investors as alternate ways of attracting foreign capital. For now, however, the IMF figures appear to indicate that the external borrowing binge is continuing.

Real Estate: How Big a Risk to the Economy?

¶8. (C) There is consensus among observers that a lot of the capital borrowed abroad by Kazakhstani banks ends up flowing into domestic real estate. There appears to be agreement among top Kazakhstani bankers that the real estate markets in Almaty and Astana pose risks. However, the bankers differ in the levels of their concern and their approaches to mortgage lending. The National Bank's Aimanbekova said that the real estate market is being driven by "speculative, not real, demand," and that "problems" are expected in 2008. She blamed the excess demand on Kazakhstan's shadow economy, which produces large sums of money in need of laundering. (Note: for discussion of Kazakhstan's shadow economy, see Ref ¶A. End note.) Balgarin of Centras seconded this view: compared to securities investments, he said, real estate investments enjoy a high level of non-transparency, making them an ideal vehicle for "parking" illicit capital. Greater transparency of the oil sector, Balgarin added, would lessen pressure on the real estate market and "spread money around."

¶9. (C) Grigoriy Marchenko, the CEO of Halyk Bank and former NBK Chairman, echoed Aimanbekova's comments, telling us on April 17 that real estate prices are "the biggest industry risk for the banking system" and that a correction could come in 2008. Marchenko emphasized his bank's "contrarian" orientation in treading carefully in the real estate sector. Yet even he qualified his pessimism: while the real estate market, he said, is overpriced in Astana and Almaty, it remains "very segmented" and still has room to grow "in the provinces."

¶10. (C) BTU's Solodchenko -- who described his bank as "not the most aggressive one" in the context of real estate (that title, he said, belongs to KKB) -- provided a mixed view. He said that Kazakhstan -- with a living space per capita figure of 17 square meters -- still has some catching up to do with Eastern Europe's 34 square meters per capita. Solodchenko added, however, that his bank has now pulled out of Astana's real estate market, which is approaching "saturation" at

22-23 square meters per capita. Still, he stated, the real increase in housing in Almaty is not as great as it may appear. The first floors of many residential buildings, Solodchenko explained, have been converted to retail stores. The need to replace this "lost" residential space, combined with the continuing post-Soviet "decompression" of extended families crammed into single apartments, is often viewed as at least partly responsible for driving the demand.

¶11. (C) Auezov of KKB, Kazakhstan's largest bank, readily acknowledged his bank's substantial involvement in the real estate sector. However, he said, KKB's risk is "particularly structured." Auezov explained that KKB focuses on financing construction, including construction of industrial and governmental buildings. This preference for "construction risk," he implied, helps insulate KKB from the risks of the real estate market's fluctuations. Mukhtar Bubeyev, Department Head at the Financial Supervision Agency (FSA), expressed a similar perspective, stating that Kazakhstan's banking sector is "quite diversified." The real exposure to the real estate market, he said, is shouldered by mortgage companies, which also fall under FSA's purview.

After Valut Transit Debacle: How Good is the Oversight?
-- ----------

¶12. (C) Most observers do not see the recent collapse of the Karaganda-based Valut Transit Bank (VTB) as an indication of

systemic problems in Kazakhstan's banking system. (Note: Ref D reports the legal proceedings surrounding VTB. End note.) The consensus appears to be that the VTB's downfall was precipitated by unmistakably "criminal" factors. Balgarin of Centras framed the saga in terms of corporate governance; the bank, he said, issued a lot of credit to finance its own stockholders' projects. Other observers echoed this view but differed somewhat in their assessment of the regulator's (i.e. the FSA's) fault in the bank's downfall. Bakhyt Mazhenova, General Director of the Deposit Insurance Fund, shared her personal opinion with us that "politicization" and "weakness" of the FSA prevented it from spotting and bringing to light the VTB's troubles in a timely fashion. Other observers also thought that the FSA may have been excessively timid and slow to the scene, particularly in pulling the sinking bank's license.

¶13. (C) Halyk's Marchenko, however, painted a picture of a largely blameless FSA, which was simply prevented from doing its job by a lack of power and a faulty legal system. It was essentially impossible, Marchenko said, for the regulator to unravel the multi-layered loan scheme at the center of the VTB's demise. Any action the FSA takes, he explained, can be challenged in court. Marchenko added that in the VTB case the FSA likely assumed that it would lose such a challenge, "even if (the bank) had not bribed the judge - a big if." FSA's Bubeyev, while sounding rather defensive about the VTB scandal, appeared to support Marchenko's thesis. In the wake of the VTB's bankruptcy, Bubeyev said, legislative amendments have been enacted, expanding the FSA's powers. The legislation, in part, dictates that the FSA's instructions must be followed even if they are being challenged in court.

¶14. (C) Marchenko suggested that knowledgeable domestic investors, particularly large financial institutions (including Halyk), had pulled their investments out of VTB in time to avoid falling victim to the bank's collapse. On the other hand, foreign institutions and domestic depositors, Marchenko added, could not see the trouble coming.

¶15. (C) The ripple effects for Kazakhstan's financial sector of the collapse of the VTB are, according to a discernible consensus, rather limited. Mazhenova of the Deposit Insurance Fund (DIF), "Kazakhstan's FDIC," however, stated that the impact on the banking system would have been "big," had the DIF not made payments to the VTB's depositors. The DIF's actions, she said, prevented a major outflow of capital from the banking system following the VTB's collapse. Mazhenova said that the failed bank served 100,000 depositors and held 250,000 accounts. Mazhenova described the VTB as a "large regional bank" and a key player in the economy of the industry-heavy Karaganda Oblast. The DIF, she said, insures bank deposits up to the amount of KZT 700,000 (approx. $5,833); 52% of VTB's deposits were under that threshold. Mazhenova stated unequivocally that the VTB meltdown is taking a major financial toll on the DIF, resulting in obligations of approximately KZT 15 billion (approx. $125 million). She added that a decision has been made to grant

to the DIF an inflow of capital, possibly to the tune of 5 billion KZT (approx. $41.7 million), from the National Bank.

New Horizons and Where the Buck Stops...

¶16. (SBU) In spite of the clouds of the VTB debacle and excessive external borrowing by banks, Balgarin of Centras presented an optimistic vision of the Kazakhstani financial sector's foreseeable future. The asset management and insurance industries, he said, lag behind the "very well-developed" banking sector but have great potential. Balgarin added that insurance companies may receive a major impetus if existing pension funds come under their management. While the lack of "financial literacy" among the Kazakhstani public remains an obstacle, he said, "the public

mind is evolving." As evidence, he cited $20-22 billion now in deposits and $400 million under asset management, although only 15-20% of the latter is "active on the market."

¶17. (C) Balgarin was decidedly gloomier when discussing issues of corporate governance. He said that the lack of transparency is a problem, and that it is very difficult for a shareholder to influence a company. "The problem," Balgarin stated, "is not legislation but the legal system and the culture. When it comes to enforcing rights, the buck stops at the courthouse steps." Balgarin's remark was a clear allusion to the notion that the fate of the Kazakhstani financial services industry is strongly tied to that of the domestic corporate sector, which remains plagued by poor corporate governance and the legal system's failures in enforcing contractual and property rights.

Comment

¶18. (SBU) Whatever the extent of the risks that Kazakhstan's overindulgence in foreign debt brings to the global financial system, the phenomenon certainly exposes Kazakhstan's banking system to external risks, particularly higher interest rates. Should global interest rates rise, Kazakhstani banks may find it difficult to refinance their maturing -- and mushrooming -- debt. A possible switch in focus from debt to equity may alleviate this concern. Concern will remain, however, over the quality of the banks' investments and loans, particularly in real estate.

¶19. (SBU) The optimists' assessment that Kazakhstan's banking sector is relatively impervious to a possible bursting of the real estate bubble understates the wider socio-economic effects of a truly hard landing. Astana and Almaty's construction boom relies on the cheap labor of untold numbers of Central Asian migrants, who will abruptly and collectively become unemployed if the real estate music stops. Furthermore, many middle-class Kazakhstanis in Astana and Almaty - many with mortgages - have invested large portions of their net worth in newly built apartments. A wave of foreclosures would be a phenomenon both unprecedented and deeply worrying for an important layer of Kazakhstani society. While well-informed observers increasingly mention 2008 as the year when the real estate market is likely to peak, the behavior of market bubbles is notoriously difficult to predict. End comment.
GILMER